Fiscal policy still holds the key; range-bound through the summer lull

PBoC announced benchmark rate cut and designated RRR cuts on Saturday
The PBoC announced at 5pm, on 27 June, that it would cut the benchmark interest rate by 25bps, lower by 50bps the RRR for designated banks whose lending to rural borrowers and small and medium enterprises is above a certain threshold, and reduce by 300bps the RRR for finance companies.

Monetary accommodation has been abundant; fiscal policy still holds the key
The benchmark interest rate cut is largely in line with market expectations. We actually suggested the likelihood of an imminent rate cut in our 12 June note Five things you need to watch in June, based on our economists’ forecasts and the observation that PBoC rate cuts have been closely following UST yield surges since 4Q14 (Figure 1). However, the designated RRR cuts are a surprise to us and the market and may have a lot to do with the recent 20% A-share sell-off in the past two weeks.

Range-bound with heightened volatility through the summer lull
The decisive PBoC rate and designated RRR cuts on Saturday indicate the existence of “policy put” and may interrupt the downward spiral in A-share de-risking and deleveraging that we have seen in the past two weeks. Accordingly, we would not be surprised to see a technical bounce this week. However, we do not expect a bull-run to resume any time soon, considering:

1. Waning liquidity support: The 20% A-share plunge in the past two weeks is providing a real risk education for both Chinese authorities and domestic investors regarding the power of leverage when the market drops. We believe this may reinforce leadership’s intention to rein in A-share leverage (especially shadow margin financing) to stem systemic risks. Domestic investors may also want to reduce leverage from the current elevated level (Rmb2tr, or 3.5%/8% of total/free-float market cap; see Figure 2), suggesting less liquidity inflow to A-shares. What’s more, if the policy easing cycle comes to an end by 3Q15 as our economist forecasts, system liquidity conditions may plateau and stop improving.

2. Intensifying global uncertainty: Global investors’ risk appetite may continue to be weighed by uncertainties around Fed lift-off and

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development in Greece; this may be particularly true for H-shares given their tighter linkage with global markets. Specifically, our US economist notes that financial markets have priced in fewer Fed rate hikes by end-2015 than the Fed had projected (Figure 3; see Are markets losing patience with the Fed’s patience?). For Greece, our European economist thinks one cannot rule out possible scenarios such as non-payment plus capital controls and a referendum; a Staff Level Agreement is no panacea either (see Greece Update: Final Countdown).

3. Unattractive valuations: Chinese equity valuations have softened visibly since the recent market decline, but we still we don’t find them compelling. Specifically, A-share large-caps as measured by CSI300 trade at 15x 12-month forward P/E, while non-financial CSI300 is still as high as 21x (Figure 4), and small-cap CSI500 stand at a lofty 34x, or a 2.6x standard deviation higher than the historical mean (Figure 5). Looking at the distribution of A-share 12-month trailing P/E, there are still 1800+ A-shares or 46% market cap trading above 50x (Figure 6). The equal-weighted All-A-shares trade at a very rich 142x 12-month trailing P/E, higher than the previous peak of 134x seen in 2007 (Figure 7). CSI300 annualized trading velocity stands at 1379% or an 18-day average holding period vs. 150% or 167 days in MSCI China (Figure 8). H-shares as proxied by MSCI China trade at 10.8x 12-month forward P/E, while non-financials are at 14.3x, or a 13% premium to the 10-year average (Figure 9).

Given the above considerations, we think H-shares may remain range-bound with heightened volatility through the summer lull before reaching our target of 80.3 for MSCI China or 14,000 for HSCEI by end-2015. Looking forward, investors may shift their focus back to fundamentals from liquidity; we believe the key driver for the next leg up will be mainly represented by economic improvement on the back of stronger fiscal support. We will watch credit data closely over the coming months — not only headline growth but also the duration split in new bank loans and the composition of total social financing as the leading indicator of industrial activity, given their clear historical correlation (Figure 10). Sector-wise, we prefer financials, IT, industrials and utilities, while we underweight telecom and energy (Figure 11). Also see our top-10-picks portfolio in Figure 12.
Figure 1: PBoC rate cuts have been closely following UST yield increase since 4Q14; we saw a 36bps rise in 10-year UST yield before the end-June PBoC rate cut

Source: Bloomberg Finance LP, Deutsche Bank Strategy Research

Figure 2: A-share margin debt balance stands at Rmb2.2tr or 3.5%/8.0% of total/free float market cap

Source: Bloomberg Finance LP, CEIC, Wind, Deutsche Bank Strategy Research
Financial markets have priced in fewer rate hikes by year-end 2015 than the Fed had projected. Figure 3 shows the median FOMC projection versus OIS rate. The chart highlights that the market has anticipated fewer rate hikes compared to the Fed's projections.

Small-cap CSI500 stand at a lofty 34x 12m fwd P/E, or 2.6x std. dev. higher than historical mean. Figure 5 illustrates the P/E trend for the CSI500 mid/small cap index, showing values from 2006 to 2015. The historical trend indicates a significant premium compared to previous years.

The equal-weighted All-A-share trade at 142x 12-month trailing P/E, still higher than the previous peak of 134x seen in 2007. Figure 7 presents a graph of equal-weighted trailing P/E for All A-shares, ChiNext, SSE50, and CSI500, covering the period from 2006 to 2015. The chart demonstrates the relative performance and volatility of these indices.

CSI300 annualized trading velocity stands at 1379% or 18 days of average holding period vs. 167 days in MSCI China. Figure 8 compares the annualized free float velocity of CSI300 with other indices. The chart indicates a shorter holding period for CSI300 compared to MSCI China, reflecting higher trading activity.

CSI300 trade at 15x 12-month forward P/E, while non-financial CSI300 are still as high as 21x. Figure 4 presents a graph of 12m fwd P/E for CSI300 and non-financial CSI300, with premiums and deviations from the 10-yr avg. The chart shows the P/E distribution for different sectors and time periods.

1800+ A-shares or 46% market cap trade above 50x 12-month trailing P/E. Figure 6 displays the distribution of A-shares trading above 50x P/E, with a cumulative % of market cap. The chart highlights the concentration of high P/E shares and the proportion of market capitalization involved.

Source: Bloomberg Finance LP, Deutsche Bank Strategy Research
Figure 9: MSCI China trade at 10.8x 12-month forward P/E, while non-financials are at 14.3x

Source: Bloomberg Finance LP, MSCI, Deutsche Bank Strategy Research

Figure 10: Historically M2 and TSF growth lead industrial production growth by three months

Source: Bloomberg Finance LP, CEIC, Deutsche Bank Strategy Research

Figure 11: We prefer financials, IT, industrials and utilities, while we underweight telecom and energy

Source: Bloomberg Finance LP, MSCI, Deutsche Bank Strategy Research
Note: 5-year valuation z-score refers to the standard deviation from past 5-year historical average in terms 12-month forward P/E, except for financials who are based on 12-month trailing P/B.

Figure 12: Deutsche Bank 2015 China top-10 picks

Source: Bloomberg Finance LP, Deutsche Bank Strategy Research
Note: In themes, C refers to cost savers, T refers to top-line growers, R refers to reform beneficiaries, and M refers to MSCI inclusion. Deutsche Bank coverage of Citic Securities (6030.HK) is temporarily suspended due to team structure change.
Figure 13: Recent market index correction is in line with our cautious market view since mid-April

2015 Outlook:
- Rate-cut, reform & re-rating: W-shaped roadmap
- Stay put amid consolidation
- Buy H-shares: More upside, UG banks & ppt
- NT consolidation to extend
- SB volume may rise and catalyze H-share catch-up
- 3 reasons why; add downside protection
- MRF not a NT game changer

MT upside after NT volatility
5 things to watch in June

Source: Bloomberg Finance LP, Deutsche Bank Strategy Research
Appendix 1

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<td>Buy: Based on a current 12-month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield), we recommend that investors buy the stock.</td>
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